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In the Supreme Court of the United States

OCTOBER TERM, 1928

No. 481

ROBERT H. LUCAS, COLLECTOR OF INTERNAL REVENUE for the District of Kentucky, petitioner

v.

A. J. A. ALEXANDER

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the District Court of the United States for the Western District of Kentucky (R. 28-33) is reported in 21 F. (2d) 68. The opinion of the Circuit Court of Appeals for the Sixth Circuit (R. 70) is reported in 27 F. (2d) 237.

JURISDICTION

The judgment of the Circuit Court of Appeals for the Sixth Circuit was entered on June 30, 1928. (R. 69.) Petition for certiorari was filed Septem-

ber 28, 1928. Certiorari was granted November 19, 1928. (R. 75.) Jurisdiction is conferred upon this Court by Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Deferred dividend policies were issued to a taxpayer in 1899. The policies, which were fully paid up in 1908, matured in 1919. They provided that no dividend should be apportioned until maturity and then only if the insured were living. At maturity the taxpayer surrendered the policies and in addition to their face value received aggregate dividends of $20,797. Upon these facts, the question is whether in computing the taxable gain under Section 202 (a) (1) of the Revenue Act of 1918, the March 1, 1913, value should be restricted to the amount then realizable upon the policies, or whether the speculative future value to the insured if he held the policies, discounted to 1913, was the proper basis.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1918, c. 18, 40 Stat. 1057, 1060, 1065:

> SEC. 202. (a) That for the purpose of ascertaining the gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, the basis shall be—
>
> (1) In the case of property acquired before March 1, 1913, the fair market price

or value of such property as of that date;
* * *.

SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—

(a) Includes gains, profits, and income derived from * * * sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by the taxpayer, * * *;

(b) Does not include the following items, which shall be exempt from taxation under this title:

* * * * *

(2) The amount received by the insured as a return of premium or premiums paid by him under life insurance, endowment, or annuity contracts, either during the term or at the maturity of the term mentioned in the contract or upon surrender of the contract;

* * * * *

Regulations 45 (1920 Edition), Art. 87, p. 53:

ART. 87. *Income accruing prior to March 1, 1913.*—Property held by the taxpayer on March 1, 1913, is capital. * * * In the case of an insurance policy its surrender value as of March 1, 1913, may be used as a

basis for the purpose of ascertaining the gain derived from the sale or other disposition of such policy. * * *

STATEMENT

Two policies of life insurance were issued to respondent by the New York Life Insurance Company on June 5, 1899, effective May 19, 1899. The face value of each policy was $50,000. Each was described as "insurance bond with guaranteed interest" and contained provisions for participating in deferred dividends and surplus. The policies were fully paid up on March 19, 1908, after ten premium payments aggregating $78,100 had been made. Each policy contained the following provisions as to deferred dividends and surplus (R. 34):

ACCUMULATION GUARANTEES

This insurance bond participates in surplus as hereinafter provided, but no dividend shall be apportioned to it before the end of the accumulation period. If the insured elects to continue this insurance bond beyond the accumulation period under one of the two accumulation benefits first named below, no further dividend shall be apportioned to it before the end of each period of five years thereafter.

The accumulation period of this insurance bond ends on the nineteenth day of May in the year nineteen hundred and nineteen. If the insured is living and if the premiums have been duly paid to that date, and not

> otherwise, the company will then apportion a dividend to the insured, who shall have the option of continuing or discontinuing this insurance bond under one of the following four accumulation benefits: * * *.

Respondent being alive at the maturity of his policies on May 19, 1919, elected to receive the cash surrender value of the policies and received the sum of $120,797. (R. 35.) In making his income-tax return for the year 1919, respondent showed thereon, among things as income, dividends on insurance policies in the sum of $17,290.35. (R. 34.)

Upon reaudit of the said return, the Commissioner found the amount of income realized by respondent upon the surrender of the said insurance policies to be the sum of $42,697 or the difference between the cash surrender value, $120,797, and the total premiums paid, $78,100. An additional assessment in the amount of $11,334.17 resulted, of which respondent paid $8,750.91 (R. 35) and brought this suit for its recovery.

On March 1, 1913, the loan value of each of the policies was $37,300 (R. 30), a total of $74,600. It is conceded that the loan value was the equivalent of the cash surrender value (R. 30).

The District Court determined the March 1, 1913, value of these policies as follows:

The policies being fully paid up, the insurance company had provisionally set aside certain sums as the accumulation on these policies which, on March 1, 1913, amounted to $13,600. Assuming

that the same rate of accumulation would continue, it appeared at that time that this amount would grow by May 19, 1919, to the sum of $19,428.57, which, added to the face value of the policies, would make a total estimated value of $119,428.57. The present value of this sum on March 1, 1913, at 4 per cent per annum compounded annually was found to be $93,587.81, and this sum deducted from the amount actually received, $120,797, gave $27,209.19 as the taxable gain. (R. 32–33.) Judgment was rendered for the respondent on this basis. (R. 33.) This calculation resulted in a judgment for the respondent in the sum of $6,519.36. (R. 33.) This was less than the sum sued for, $8,750.91. (R. 27.) The collector brought error and the respondent cross error (R. 70) and the case was taken to the Circuit Court of Appeals for the Sixth Circuit.

That court affirmed the judgment of the District Court, and sustained the method under which it determined the March 1, 1913, market price or value of said policies as $93,587.81. (R. 73.) Certiorari was granted by this Court to review the decision of the Circuit Court of Appeals for the Sixth Circuit.

SPECIFICATION OF ERRORS

The Circuit Court of Appeals erred in holding that the taxable gain realized by the respondent, upon surrender by him at maturity of the two insurance policies involved in this case, was only $27,209.19; and in failing to hold, under the provisions of Sections 213 (b) (2) and 202 (a) (1),

Revenue Act of 1918, *supra*, that the taxable gain realized by the respondent was the difference between the sum paid by the insurance company, $120,797, and the total of premiums paid, $78,100, without interest, or $42,697.

SUMMARY OF ARGUMENT

On March 1, 1913, the only realizable value of the insurance policies was the cash surrender value. Cash surrender value has always been used as an index of the value of life insurance policies. The Bankruptcy Act permits a bankrupt to pay the amount of the surrender value to the trustee in redemption of his insurance policy. It was the purpose of the Bankruptcy Act to give the full value of the policy to creditors and the cash surrender value was specified as the equivalent of the full value. If it is the full value for the purpose of administering the Bankruptcy Act, there is no reason why any greater value should be adopted under the Revenue Acts. The Revenue Act of 1918 does not contemplate the computation of gain or loss by reference to contingent and speculative values which may later accrue. Accordingly, the basis for determining gain or loss under Section 202 (a) (1) of the Revenue Act of 1918 would be the cash surrender value of these policies on March 1, 1913, in the amount of $74,600. However, in view of the provision of Section 213 (b) (2) of the statute, the gain in this case was computed upon the basis of the total amount of premiums paid, $78,100.

ARGUMENT

THE VALUE OF A LIFE INSURANCE POLICY ON MARCH 1, 1913, SHOULD BE RESTRICTED TO ITS REALIZABLE VALUE DISREGARDING ALL SPECULATIVE OR CONTINGENT VALUES WHICH MAY LATER ACCRUE

The problem in this case is to determine the gain derived by respondent upon the disposition of property acquired before March 1, 1913. Section 202 (a) (1) of the Revenue Act of 1918 specifically provides that the basis for such determination is the fair market price or value of such property as of that date. The property here consisted of policies of insurance which were not salable. Therefore, the basis in the case at bar must be the fair market value as of March 1, 1913. In computing that value petitioner contends that it must be restricted to the realizable value.

The only realizable value of these policies on March 1, 1913, was the cash-surrender value. The policies contained no schedules of cash-surrender value. However, they did contain schedules of loan values which, it is conceded, had the same effect as cash-surrender value. (R. 30.) In any event a cash-surrender value exists whether or not recognized by the policy. *Richter* v. *Rockhold* (C. C. A. 5th), 253 Fed. 941. Cash-surrender values have always been used as an index of the value of life insurance policies. *Hiscock* v. *Mertens*, 205 U. S. 202, 212; *Appeal of E. A. Armstrong*, 1 B. T. A. 296. Aside from that they could not be said to have any appreciable value. *In re Newland*, 18 Fed. Cas. 90.

Article 87 of Regulations 45 (1920 edition) provides:

> In the case of an insurance policy its surrender value as of March 1, 1913, may be used as a basis for the purpose of ascertaining the gain derived from the sale or other disposition of such policy.

Similar language is contained in all of the subsequent regulations. (Article 90, Regulations 62; Article 90, Regulations 65; Article 90, Regulations 69.)

Section 70 (a) of the Bankruptcy Act (Act of July 1, 1898, c. 541, 30 Stat. 544, 565) recognizes no other value and permits the bankrupt to retain his policy free from the claims of creditors upon payment to the trustee of the amount of the cash surrender value.

In *Burlingham* v. *Crouse*, 228 U. S. 459, the full amount of the surrender value had been loaned by the company and the Court held that "the speculative right to the net proceeds of the policies" did not pass to the trustee. This Court further said:

> (p. 472.) Congress recognized also that many policies at the time of bankruptcy might have a very considerable present value which a bankrupt could realize by surrendering his policy to the company.
>
> * * * * *
>
> (p. 473.) We think it was the purpose of Congress to pass to the trustee that sum which was available to the bankrupt at the time of bankruptcy as a cash asset, * * *.

The purpose of this provision of the Bankruptcy Act was thus construed in *Frederick* v. *Fidelity Ins. Co.*, 256 U. S. 395, 397:

> This provision shows it was the purpose of Congress to pass to the trustee whatever sum was available to the bankrupt at the time of bankruptcy as cash assets to be realized on surrender of the policy, but otherwise to leave to the insured the benefit of his life insurance.

A similar construction was given in *In re Gannon* (C. C. A. 2d), 247 Fed. 932, 936, where it was said:

> The theory of the law is that the creditors of a bankrupt are entitled to everything that a bankrupt could get out of the policy by his own act at the time he was put into bankruptcy.

From these decisions we think it is clear that the Bankruptcy Act has recognized that the cash-surrender value is the full value of an unmatured insurance policy. The principle was firmly established when the Revenue Act was adopted and there is no reason why its value for tax purposes should be any greater.

The total loan value or cash-surrender value on March 1, 1913, was $74,600. (R. 31.) The premium payments on the policies were completed on March 19, 1908, and amounted to $78,100. (R. 34.) The policies were surrendered on May 19, 1919, and the company paid the respondent $120,797. (R.

35.) Except for the provisions of Section 213 (b) (2), the cash-surrender value, $74,600, would be the proper basis for determining gain or loss. However, since the statute provides that the amount received by the insured as a return of premiums shall not be included in gross income, the Commissioner computed the income realized by respondent upon the surrender of his policies to be the difference between the $120,797 actually received and the total premiums paid, $78,100. (R. 35.) Since this resulted in a smaller taxable income than would have followed from computing the gain upon the March 1, 1913, value, $74,600, no constitutional question arises.

The accumulation period under the policies ended on May 19, 1919. The policies provided that if the insured were alive on that date and the premiums had been duly paid, but not otherwise, the company would then apportion a dividend to the insured. (R. 34.) During the accumulation period the company provisionally ascertained the amounts attributable to these policies, but whether respondent would ever actually receive them depended upon his survival to the end of the accumulation period. On March 1, 1913, the total amount thus provisionally ascertained was $13,600. (R. 31.) In view of the policy provision, the insurance company was not required to and, as a matter of fact, had not, irrevocably set aside to these policies any part of the accumulations which would ultimately go to them if the insured lived out the accumulation period.

The accumulation period had not expired on March 1, 1913, and the provisional accumulations were not available to respondent upon that date. Accordingly, it is submitted that the only demonstrable value of these policies on March 1, 1913, and the only realizable value at that time, was the cash-surrender value of $74,600. To assign any larger value to the policies on March 1, 1913, it is necessary to determine present value for speculative and contingent rights which may later accrue.

It was more advantageous to the respondent to keep the policies at that time than it would have been to realize on them, but the Revenue Act does not contemplate the computation of gain or loss by reference to contingent values. Respondent's choice of a medium of investment was his own. Because he preferred to invest in property which had no sale on March 1, 1913, is no reason why a theoretical value computed by reference to some future contingent event should be adopted. The statute contemplates a realizable value, which in this case is demonstrated to have been the cash surrender value. By virtue of Section 213 (b) (2) respondent has not been restricted even to that, but has been given the benefit of the total premiums paid.

The District Court disregarded the realizable value and took into account the benefits which the taxpayer might reasonably anticipate receiving if he continued to hold the policies instead of realizing on them on March 1, 1913. Assuming that the rate

of accumulation would be maintained, it was determined that by the end of the accumulation period a dividend of $19,428.57 would be available. This depended, of course, upon the respondent living out the accumulation period, but considering his age and his expectancy of life the court found that on March 1, 1913, respondent could have reasonably anticipated receiving on May 19, 1919, the face amount of the policies, $100,000, and $19,428.57 in accumulations, or a total of $119,428.57. By the application of a four per cent interest rate, compounded annually, the present value of that sum on March 1, 1913, was calculated to be $93,587.81. This amount was treated as the fair value of the policies on March 1, 1913. By taking the difference between it and the $120,797 actually received upon the surrender of the policies, the court arrived at a taxable gain of $27,209.19.

This method of calculation was plainly erroneous. The policies had a definite, realizable value on March 1, 1913. Whether they would ever be worth more to respondent depended upon a contingency. No part of the subsequent increase in the cash surrender value can be regarded as an item in the value of the policies on March 1, 1913. Neither could the dividends which were provisionally apportioned on March 1, 1913, nor those which were apportioned later, be regarded as items entering into the March 1, 1913, value. At that time the respondent had absolutely no interest in such dividends. That was

settled by this Court in *New York Life Insurance Co.* v. *Edwards*, 271 U. S. 109, where the policies in question were like those involved in the instant case.

Not only was the share of the respondent in the company's earnings and surplus wholly contingent on March 1, 1913, but his "share of the forfeitures" was likewise contingent upon the redundancy in premium of other policyholders who might not persist in premium payments to the end of the contract period. *Penn Mutual Co.* v. *Lederer*, 252 U. S. 523, 532.

It is plain that the District Court indulged in speculation when it calculated the March 1, 1913, value of property in which the respondent had absolutely no interest on that date. The later value which accrued to these policies did not exist on March 1, 1913, and it is submitted that there is no reason or logic in applying a formula to determine the present value of something which does not exist. On March 1, 1913, the only realizable value was the cash-surrender value and the calculation of the present value of other property which accrued later is not contemplated by the statute.

The March 1, 1913, value of a life-insurance policy was involved in the *Appeal of E. A. Armstrong*, *supra*. The taxpayer in that case urged that the policy was then worth more than the cash-surrender value. However, the Board of Tax Appeals held that no theoretical or contingent values could enter

into the calculation. The Board said (pp. 297–298):

> • • • The taxpayer contended in argument that the policy was really worth a lot more than its surrender value on March 1, 1913, because other members of the tontine group had dropped out, etc., and that every time one dropped out the value of the policies of the remaining members increased; but such increased value was entirely contingent upon the taxpayer's remaining in the group until the maturity of his policy. The market or realizable value of the policy was not changed by the occasional elimination of members of the group, though the probable time of maturity may have been advanced—remaining, however, strictly contingent.
>
> The Revenue Act of 1918 does not contemplate the computation of gain or loss by reference to contingent values. A taxpayer who owned an asset before March 1, 1913, and disposed of it thereafter is entitled in computing profit to subtract from the selling price the capital value which he held on March 1, 1913 (or the cost to him, if higher), plus any additional cost incurred after March 1, 1913, with proper adjustments for values recovered through depreciation, etc. The capital value so recoverable must be a market value, a realizable value—not a theoretical value computed by reference to some future contingent event.
>
> • • • • •
>
> The capital value at March 1, 1913, which the taxpayer is entitled to have returned be-

> fore he can be said to have had taxable profit will be the cash surrender value of the policy at that date plus any accumulated dividends or excess premiums which had been credited to him in such a way that he could have realized them had he surrendered the policy on March 1, 1913. Any greater value would be purely speculative and contingent, and can not be made the basis for computing taxes.

In thus restricting the March 1, 1913, value of an insurance policy to the value definitely realizable upon that date, it is submitted that the Board of Tax Appeals applied the correct principle. There is no precedent for any other basis of valuing an insurance policy.

The Circuit Court of Appeals sustained the basis of determining the March 1, 1913, value which had been adopted by the District Court upon the theory that if the policies had been salable their market value would have been not less than the amount computed by the District Court, $93,587.81. Of course, if the nature of the property had been different and there had been a ready market for it, a different result would be reached. Since they were not salable, the Circuit Court of Appeals decided that the policies were worth that much to the insured. In so proceeding, we submit that the court lost sight of the fact that the statute contemplates no other basis than realizable value. There is no latitude for indulging in speculation with regard to what property is worth to an owner who does not

sell. The only market for these policies was the insurance company which issued them and the full amount which could have been received by the respondent on March 1, 1913, was the cash surrender value, $74,600.

The Circuit Court of Appeals has considered the word "value" as used in the statute as opposed to fair market price and given it the meaning of "value to the owner." This is clearly erroneous. The statute comprehends fair market price or fair market value. The later statutes employ the term "fair market value" alone. (See Section 204 (b), Revenue Act of 1924, c. 234, 43 Stat. 253, 259, U. S. C., Title 26, Sec. 935; Section 204 (b), Revenue Act of 1926, c. 27, 44 Stat. 9, 16, U. S. C. App., Title 26, Sec. 935; Section 113 (b), Revenue Act of 1928, c. 852, 45 Stat. 791, 821.)

The method adopted by the court in valuing the contract involved in *Kentucky Tobacco Products Co.* v. *Lucas*, 5 F. (2d) 723, establishes no precedent for the method of valuing the life-insurance policies in the instant case. On March 1, 1913, the company in that case had an unexpired contract which enabled it to purchase tobacco stems at $8.51 per ton. The evidence showed a community of interest between the parties which accounted for the favorable contract price. About that time the company had been offered as much as $35 per ton for a limited quantity of the stems it was receiving under the contract and it was shown that $23.38

per ton was a fair value for such stems for the unexpired period covered by the contract.

While the court in that case applied a formula to determine the March 1, 1913, value of future speculative earnings, the facts in the case showed that the company practically controlled the supply of stems through its favorable contract and that at the expiration of the contract it could not profitably continue its business. Thus the speculative elements were reduced to a practical certainty and the case is *sui generis* and does not establish any precedent. Particularly is this true when dealing with a life-insurance contract. "While life insurance is property, it is peculiar property," *Burlingham* v. *Crouse*, 228 U. S. 459, 472, and we submit that the principle limiting the value of a life-insurance policy to its cash-surrender value is too well settled to permit a greater value to be assigned to such property for tax purposes.

CONCLUSION

For the reasons stated, we respectfully submit that the judgment of the court below should be reversed.

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FEBRUARY, 1929.

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